

**Performance Audit
Reporting Requirements for
Non-Pension Retiree Benefits**

July 2005

City Auditor's Office

City of Kansas City, Missouri

July 19, 2005

Honorable Mayor and Members of the City Council:

This performance audit was initiated by the City Auditor pursuant to Article II, Section 13 of the city charter. The audit focuses on determining whether the city is taking appropriate steps to address the changes in reporting requirements for non-pension retiree benefits.

The Governmental Accounting Standards Board (GASB) issued statement 45 in June 2004, requiring employers to measure and report the long-term costs of retiree health and other non-pension benefits. The city is required to implement GASB 45 in financial reports for fiscal year 2008. These costs are not new, however, while the city currently pays for these benefits as the bills are received (known as a “pay-as-you-go” basis), GASB 45 will require annual reporting of both the bills received and a portion of future obligations. Once the city determines by actuarial study the total costs of these benefits, the city will be required to provide annual contributions to fully fund it, or future financial statements will include a net liability for the shortfall, which might adversely affect the city’s bond rating.

The Finance Department has taken reasonable steps to address GASB 45. Finance staff read statement 45, discussed it with the city’s external auditors and financial advisors, identified the non-pension benefits currently provided, and requested funds for an actuarial study to determine the total costs for all four pension systems. Once the liability is determined, the city will have two options: annual contributions to fully fund the costs or deferring future costs, creating a net liability that will have to be reported on future financial statements. Additionally, the city could modify the non-pension benefits to current and future retirees.

We recommend the City Manager ensure the actuarial study is completed as soon as possible. Once completed, the City Manager should evaluate the funding and benefit options available to the city. The City Manager should then develop a plan to address GASB 45 reporting requirements and present the plan to the City Council for deliberation.

We provided a draft report to the City Manager and the acting Finance Director for review and comment. Management’s response is included as an appendix. We appreciate the courtesy and cooperation of city staff as we completed this audit work. The team for this project was Vivien Zhi and Gary White.

Mark Funkhouser
City Auditor

Reporting Requirements for Non-Pension Retiree Benefits

Table of Contents

Introduction	1
Objectives	1
Scope and Methodology	1
Background	2
What Are Non-Pension Retiree Benefits?	2
City Has OPEB Obligations	3
Findings and Recommendations	5
Summary	5
City Taking Appropriate Steps to Address GASB 45	5
Finance Has Taken Steps to Address GASB 45	5
Options to Address City's OPEB Liability	6
Difficult Policy Decisions Are Needed	8
Recommendations	8
Appendix A	9
City Manager's Response	9

List of Exhibits

Exhibit 1. Options for Funding OPEB Liability	7
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Introduction

Objectives

We conducted this audit under the authority of Article II, Section 13 of the Charter of Kansas City, Missouri, which establishes the Office of the City Auditor and outlines the City Auditor's primary duties.

In June 2004, the Governmental Accounting Standards Board (GASB), issued statement 45, requiring employers to measure and report the long-term costs of retiree health and other non-pension benefits. The city is required to implement GASB 45 in financial reports issued for fiscal year 2008. This audit was completed to assess the city's efforts to ensure compliance with GASB 45 and identify funding and benefit modification options available to the city once the total liability is determined.

A performance audit independently and systematically examines evidence to assess the performance and management of a program against objective criteria. Performance audits provide information to improve program operations and facilitate decision-making.¹ This report is designed to answer the following question:

- Is the city taking appropriate steps to comply with GASB 45 requirements?

Scope and Methodology

We conducted this audit in accordance with generally accepted government auditing standards. Our methods included:

- Interviewing city, police, and retirement systems staff.
- Reviewing GASB 45: *Accounting and Financial Reporting by Employers for Post Employment Benefits Other Than Pension*.

¹ Comptroller General of the United States, *Government Auditing Standards* (Washington, DC: U.S. Government Printing Office 2003), p. 21.

- Reviewing actuarial studies on the city's four retirement systems.
- Interviewing staff at Government Finance Officers Association to identify options available to comply with GASB 45.

We omitted no privileged or confidential information from this report.

Background

What Are Non-Pension Retiree Benefits?

Non-pension retiree benefits include healthcare or life insurance benefits provided following employment. Although received by employees after their employment has ended, they are considered part of the total compensation offered to attract and retain the services of qualified employees. All non-pension benefits are classified as other post employment benefits (OPEB).

The Governmental Accounting Standards Board (GASB) determined that OPEB are an accrued cost, similar to pensions, that should be reflected in government financial reports. Under GASB 45, governments are required to report the full cost of OPEB in future financial statements.

Non-pension benefit costs the city currently pays will soon need to be reported. The city currently finances OPEB costs at about the same time and in about the same amount as benefits and expenses becoming due. This method is known as "pay-as-you-go." GASB 45 requires detailing these costs in future financial statements.

Future obligations will soon also need to be reported. OPEB benefits, once promised to employees, continue as long as the employer chooses to provide them. Currently most governments, including Kansas City, do not report the long-term financial implications of OPEB commitments in their financial statements. GASB 45 requires governments to identify and report future OPEB costs.

Annual required contributions will include normal costs and a portion of future obligations. Once the city's future OPEB costs are identified, GASB 45 allows governments to amortize these costs for up to thirty years. An annual contribution of both the normal cost and the amortized portion of future OPEB obligations must be contributed by the city. If it is not, the difference between the funding provided and the annual contribution needed creates a net OPEB liability, which must be

reported in the city's financial statements. A net OPEB liability could negatively impact the city's bond ratings.

OPEB costs also include an implicit rate subsidy. Healthcare costs are expected to increase with age. Consequently, health insurance premiums for retirees are higher than premiums for active employees. Kansas City, like many employers, chooses to combine retirees and active employees when seeking health insurance. As a result, a portion of the health insurance premium paid by active city employees subsidizes the premiums of retirees. GASB also requires this subsidy be identified and included when calculating the full costs of OPEB.

Implicit Rate Subsidy Example

An employer has 400 active and 100 retired employees with the following monthly healthcare costs and age-adjusted premiums:

<u>Employees</u>	<u>Number</u>	<u>Cost</u>	<u>Rate</u>
Active	400	\$80,000	\$200/employee
Retired	100	40,000	\$400/employee

Combine both groups and the costs and rate would be as follows:

<u>Employees</u>	<u>Number</u>	<u>Cost</u>	<u>Rate</u>
Everyone	500	\$120,000	\$240/employee

The health insurance rate for retirees would be \$160 less while the rate for active employees would be \$40 more. GASB describes this \$40 as an implicit rate subsidy of retirees. GASB 45 requires identifying the difference in retiree rates caused by combining both groups and including it in the calculation of OPEB costs.

Source: "GAAFR Review," The Government Finance Officers Association's Newsletter on Governmental Accounting, Auditing, and Financial Reporting.

City Has OPEB Obligations

There are four pension systems within the city: employees, firefighters, Police, and Police civilian retirement systems. Currently city employee retirees have access to health and dental insurance and a \$2,000 life insurance policy. Retired firefighters have access to health and dental insurance. The Police Department offers health insurance, dental insurance and life insurance. Police Department retirees pay 100 percent of the premium, which is 30 percent more than the active employee premiums.

Reporting Requirements for Non-Pension Retiree Benefits

The city is required to report OPEB costs in fiscal year 2008.

Governments with annual revenues of \$100 million or more are required to implement GASB 45 in financial statements for periods beginning after December 15, 2006. For the city, the new standard will be effective for the fiscal year beginning May 1, 2007.

Findings and Recommendations

Summary

The city has taken reasonable steps to address GASB 45. Finance Department staff have read statement 45, discussed it with the city's external auditors and financial advisors, identified what OPEB obligations are provided, and have requested funds for an actuarial study to determine the total OPEB liability for all four pension systems.

Once the liability is determined, the city will have two options: annual contributions to fully fund the liability or "pay-as-you-go," an option which will result in an unfunded liability being reported on future financial statements. Additionally, the city could consider modifying the non-pension benefits offered to current and future retirees to reduce the OPEB liability.

The City Manager should ensure the actuarial study is completed as soon as possible. Once completed, the City Manager should evaluate the funding and benefit options available to the city. The City Manager should then develop a plan to address the GASB 45 requirements and present the plan to the City Council for deliberation.

City Taking Appropriate Steps to Address GASB 45

The Finance Department has taken reasonable steps to address GASB statement 45, including reviewing the statement, identifying OPEB obligations, discussing GASB 45 with the city's external auditors and financial advisors, and requesting funds for an actuarial study to determine the total OPEB liabilities for all four pension systems. Once the liability is determined, the city faces difficult decisions on how to fund the liability and whether to modify non-pension benefits offered to retirees.

Finance Has Taken Steps to Address GASB 45

The Finance Department has taken reasonable steps to prepare for GASB 45 implementation, including requesting an actuarial study to identify the OPEB liability, a necessary step to determining how to fund it.

The Finance Department is responsible for the city's financial statements. To prepare for GASB 45 implementation, department staff have:

- Read GASB statement 45 and determined the reporting requirement.
- Reviewed the requirements of GASB 45 with the city's external auditors (KPMG).
- Met with Human Resources staff to identify the OPEB benefits the city offers.
- Asked the city's financial advisors to provide information on how GASB 45 will impact the city's credit ratings.
- Submitted a decision package to the Office of Management and Budget for the fiscal year 2006 budget to pay for the cost of actuarial calculations of the city's OPEB liability.

Finance sought funds for an actuarial study. The Finance Department requested funds to have an actuarial study for all four retirement systems performed during fiscal year 2006. The actuarial study will determine the amount of the city's OPEB liability. The decision package states that "with this information the city can then plan ahead in formulating the FY 2007 and FY 2008 budgets and make a determination of whether or not we would want to pre-fund the annual required contribution during FY06 and/or FY07."²

After receiving the actuarial study, Finance staff said they will inform the City Manager and Budget Officer what the annual required contribution and actuarial accrued liability will be. The City Manager can then determine whether he wants to pre-fund the liability in fiscal year 2007, or report the net OPEB obligation in the fiscal year 2008 financial statements.

Options to Address City's OPEB Liability

The city has some options to address the GASB 45 requirements. GASB does not require the city to fully fund OPEB costs. The city can choose to fully fund the costs, or continue to operate on a "pay-as-you-go" basis. See Exhibit 1 for the advantages and disadvantages of each option.

² *Finance Department Proposed Budget for Fiscal Year 2006*, October 25, 2004.

Exhibit 1. Options for Funding OPEB Liability

Option	Advantages	Disadvantages
Fully fund the annual required contribution	<ul style="list-style-type: none"> • No net OPEB liability. • Protects bond rating in the long-run. As a result, it will help save money on future borrowing. • Provides an incentive to explore options that will better manage the costs. 	<ul style="list-style-type: none"> • Have to identify a funding source. • Opportunity costs – the money funding the liabilities cannot be used for other programs. • Cost pressure increases due to decreasing state and federal funding. • Cost pressure increases as the number and life expectancy of retirees increase.
“Pay-as-you-go” or partially fund the annual required contribution	<ul style="list-style-type: none"> • Limits annual expenditures. • Maintains the city’s current financial flexibility. • No change in current benefits. 	<ul style="list-style-type: none"> • OPEB liability will grow and could negatively impact the city’s financial statements. • Future annual required contributions may increase. • Limited incentive to manage the cost. • Could adversely affect future bond ratings.

The city can also modify non-pension benefits. In addition to the funding options, the city can decide to modify benefits or increase employee or retiree contributions.

Possible Non-Pension Benefit Modifications

- Change the health care plan to make it less expensive – increasing co-pays and deductibles, decreasing prescription coverage and making other program changes – which may result in moderate cost reductions.
- Change/institute a vesting schedule for benefits. Employers may increase the years of service required for retiree benefits and create a schedule of the percentage of costs the employer will pay.
- Decrease the employer portion of health care retirement costs. Maintaining employee retirement health benefits at the current level may not be possible. Collective bargaining on retirement benefits will be contentious, but ultimately layoffs and other drastic budget cuts may be required if the costs to fund the program are not reduced.

Kathy Harm, “A pox on your budget: retirement health benefits bode ill for local finances,” *American City & County*, February 2004.

According to a survey by Fitch Ratings, about 61 percent of the survey respondents had increased or planned to increase employee premium contributions, copays, and/or deductibles to control costs.³

Difficult Policy Decisions Are Needed

The actuarial study will determine the amount of the city's OPEB liability. Based on this information, the City Manager will need to evaluate the funding options and present them to the City Council. Decisions will be needed on how to fund the liability, i.e., fully fund it or continue the "pay-as-you-go" approach. The city could also reduce the liability by modifying the non-pension benefits provided to retirees.

Decisions on how to address GASB 45 reporting requirements rest with the City Council. Difficult policy decisions such as when to fund the benefits and whether to modify future non-pension benefits could anger either taxpayers, current and former employees, or everyone. The City Council should be provided sufficient time and information to make these decisions in an open forum. The City Manager should develop a plan for addressing GASB 45 reporting requirements and provide the City Council with information necessary to evaluate the options.

Recommendations

1. The City Manager should ensure the actuarial study is completed as soon as possible.
2. The City Manager should develop a plan for addressing GASB 45 reporting requirements and present it to the City Council for deliberation.

³ Robert Barkin, "Under Pressure," *American City & County*, February 2005, p. 38.

Appendix A

City Manager's Response

Reporting Requirements for Non-Pension Retiree Benefits

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HEART OF THE NATION



KANSAS CITY
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Office of the City Manager

29th Floor, City Hall
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Kansas City, Missouri 64106

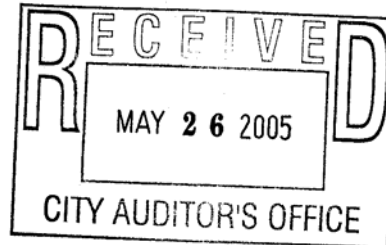
(816) 513-1408
Fax: (816) 513-1363

DATE: May 25, 2005

TO: Mark Funkhouser, City Auditor

FROM: Wayne A. Cauthen, City Manager

SUBJECT: Response to Recommendations in the Performance Audit on Non-Pension Retiree Benefits



The recent audit of Kansas City's handling of reporting requirements for Non-Pension Retiree Benefits conducted by your department has surfaced two recommendations. I find the audit to be a fair and accurate. As the report indicates, the City is taking reasonable steps to address the implementation of Government Accounting Standards Board Statement No. 45 (GASB 45).

Recommendation 1: *The City Manager should ensure the actuarial study is completed as soon as possible.*

Response: *Agree.* The Finance Department will coordinate with the Fire Department, Police Department, and Human Resources Department to publish an RFP this summer. The plan is to engage a contractor this summer, and include findings in the FY 06-07 budget submittal.

Recommendation 2: *The City Manager should develop a plan for addressing GASB 45 reporting requirements and present it to the City Council for deliberations.*

Response: *Agree.* Upon the completion of the actuarial study, the City will have the appropriate information, and will present it to the City Council for their full deliberation on this matter.

Cc: Wanda Gunter, Acting Director Finance Department
Gary O'Bannon, Director Human Resources
Richard Dyer, Fire Chief
James Corwin, Police Chief